



February 18, 2011

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551

Re: Docket No. R-1404 and RIN No. 7100 AD63

Dear Ms. Johnson,

On behalf of the South Carolina Bankers Association, a not-for-profit trade association representing banks and thrifts doing business in South Carolina, I submit this comment on the Federal Reserve's proposed rule that would establish debit card interchange fee standards and prohibit network exclusivity arrangements and routing restrictions. SCBA's comment focuses on three primary concerns with the proposed rule: the Federal Reserve's overly restrictive view of "reasonable and proportional" costs; the impact of these caps on community banks; and, the impact of the fact that the Federal Reserve will now be setting prices for goods and services between commercial entities.

Reasonable and Proportional Costs

The Dodd-Frank Act interchange amendment directs the Federal Reserve to determine a "reasonable and proportional" fee for the amount a bank may charge a merchant on each transaction to use the debit card payment network - a network created by the banking industry. Although the proposed rule outlines two alternatives for computing reasonable and proportional costs, by allowing no more than 12 cents per transaction the proposed rule falls far short of recognizing the realistic costs of designing, maintaining and improving the U.S. payment system.

Even though the Federal Reserve found that the average interchange fee was 44 cents (a fee that incorporates all costs), the proposed rule allows for only the *processing* costs of a debit transaction - 11.9 cents per transaction. Obviously, though, processing costs are only a portion of the costs involved in offering debit card services. The costs banks actually incur by offering these services include: network fees, the cost of inquiries and disputes, fraud losses and fraud prevention costs, fixed costs, including capital investments, and reasonable profit.

The Federal Reserve's 12 cent proposal allows such a limited return on each debit transaction that it would result in a 70-85 percent cut in revenue – a loss of revenue

amounting to more than \$14 billion to a banking industry that could otherwise be using this revenue to drive economic recovery. Setting the allowable fee so low guarantees that debit systems will now be unprofitable; the result being not only that maintaining them will be untenable but there will be no financial incentive for innovation. This is an important point – it is the financial industry – not the merchants – that designed and provided these highly efficient systems. Indeed, the merchants have benefitted greatly from being able to offer these systems to their customers. Innovation for even more efficient systems in the future will not come from the merchants pocketing their newfound profit; it will come from a financial industry that is properly compensated and thus incentivized to create these new systems.

The South Carolina Bankers Association strongly urges the Federal Reserve to revisit its 12 cent transaction fee cap and place a cap at a level that not only reflects the true costs of the transaction but also allows for future innovation.

The Effect on Community Banks

The Dodd-Frank Act “exemption” for banks with less than \$10 billion in assets is nothing more than an exemption with no effect and the Federal Reserve must understand the impact of this rule on banks with this supposed “exemption.”

First, this “exemption” is illusory as the marketplace will do what it always does – drive business to the lowest cost option. Merchants – especially big box retailers – will have an incentive to encourage consumers to only use debit cards offered by large banks subject to the cap, prompting them to move their checking accounts and maybe even sever the relationship they have with their local bank entirely. So even if smaller banks aren't subject to the price caps, they will not be protected from the impact of this rule.

Community banks also do not have the capacity to absorb the losses caused by these price controls that a larger bank would. So, with caps set to no more than 12 cents, community banks may simply be priced out of offering these services – thus reducing availability for consumers. At the very least, the result for small banks is either a loss of market share, a loss of revenue that supports low-cost accounts and other valuable services, or both.

Government Setting Prices Between Commercial Entities

The South Carolina Bankers Association strongly believes that government setting prices between commercial entities is simply bad public policy. Although SCBA understands that the Federal Reserve is acting under the direction of Congress via the Dodd-Frank Act, the Federal Reserve must appreciate that this proposed rule will be nothing less than government setting a price cap on the costs of a service provided from one commercial entity to another.

One problem with this is that when government attempts to establish a price in the market it cannot do this as well as the market itself for one simple reason – it is not a participant

in the transaction. It is the participants that assume the risk of innovation, demand, maintenance and fraud and can then truly come to a fair price. Since government is not a participant it assumes none of this risk and therefore does not have the capacity to set a fair price.

Secondly, government interference in the market setting process will inhibit banks and other businesses from further investing in the system or creating a new and improved system if the government will insert itself after the fact, limiting recovery of costs and adequate return on investment. Government interference will disrupt a card payments system that is easier, faster, safer and more reliable than paying with cash or checks; a system that is extremely efficient – capable of processing over 10,000 transactions per second.

Conclusion

Interchange is a fee paid by retailers and businesses in exchange for access to a card payments system that is more efficient and cost effective than cash or checks. It is a transaction between two businesses and the fee is a fair cost of doing business. The debit card system allows retailers and businesses to sell their products faster, easier and more conveniently. It also makes sure the funds necessary to run the system – and fight fraud – remain available.

The South Carolina Bankers Association respectfully insists that the Federal Reserve revisit its price caps and set them at levels that: 1) reflect the true costs of the debit card system, including the costs of incentivizing innovation; 2) do not harm community banks; and 3) minimize the effect that government interference in market pricing would cause.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'A. O'Neil Rashley, Jr.', with a long, sweeping horizontal line extending to the right.

A. O'Neil Rashley, Jr.
Senior Vice President and Counsel